Supreme Court, U.S.
FILED
MAR 14 1997
CLERK

No. 96-1107

IN THE
Supreme Court of the United States
OCTOBER TERM, 1996

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
TEXACO INC. AND SUBSIDIARIES,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTION PRESENTED

During the "second oil crisis" over the period 1979-1981, the Saudi Arabian Government prohibited the resale of Saudi crude at prices higher than those charged purchasers by the Saudi Government. This restriction on the resale price of Saudi crude was authorized by the King of Saudi Arabia and was unilaterally imposed by the Saudi Government, as part of its price moderation policy adopted at the urging of the U.S. Government and other consuming country governments. Was the Saudi Government restriction a legal restriction within the scope of *Commissioner v. First Security Bank*, 405 U.S. 394 (1972), thus barring the Commissioner's allocation of additional income to Texaco on sales of Saudi crude under 26 U.S.C. § 482?

LIST OF PARTIES, PARENT COMPANIES, AND SUBSIDIARIES

The names of all parties appear in the case caption. Respondent Texaco Inc. has no parent company or publicly held subsidiaries.

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RESPONDENTS' BRIEF IN OPPOSITION

STATUTE AND REGULATION INVOLVED

The controlling law in this case is section 482 of the Internal Revenue Code of 1954 and the Treasury regulation issued under section 482, as in effect during the years in issue (1979-1981). 26 U.S.C. § 482 (amended 1986); 26 C.F.R. § 1.482-1A(b)(1).[1] The Commissioner properly quotes the text of section 482 and the Treasury regulation that defines the scope and purpose of section 482, as in effect during the years in issue.[2]

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[1] 26 C.F.R. § 1.482-1A(b)(1) was redesignated from 26 C.F.R. § 1.482-1(b)(1) in 1993. This regulation applies to taxable years beginning on or before April 21, 1993. T.D. 8470, 58 Fed. Reg. 5263, 5271 (1993).

[2] The Commissioner properly quotes section 482 as in effect during 1979-1981, except that the asterisks at the end of the Commissioner's quotation of section 482 are not appropriate. Petition for

The controlling law in this case is identical to the statute and regulations considered by the Supreme Court in *Commissioner v. First Security Bank*, 405 U.S. 394 (1972)—the controlling precedent in this case.[3] Unless otherwise indicated, Respondents, Texaco Inc. and Subsidiaries ("Texaco"), will refer hereafter only to the Internal Revenue Code of 1954 and the Treasury regulations in effect during 1979-1981.

STATEMENT OF THE CASE

I. COUNTER STATEMENT OF FACTS

Texaco disagrees with the Commissioner's statement of facts. Rather than point out each omission of fact and resulting mischaracterization made by the Commissioner, Texaco will properly state the facts found by the Tax Court in this case.

The period 1979 through 1981 has been referred to as the "second oil crisis."[4] Pet. App. 41a. Over this period, crude oil prices almost tripled as a result of supply uncer-

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a Writ of Certiorari ("Pet.") 2. Another sentence was added to section 482, but it did not become effective until after 1986.

[3] The Commissioner also cites temporary regulations 26 C.F.R. §§ 1.482-1T(a) and (b) (effective for taxable years beginning after April 21, 1993), which were replaced with final regulations 26 C.F.R. §§ 1.482-1(a) and (b) (effective for taxable years beginning after October 6, 1994). Pet. 2 n.1. These temporary and final regulations are not applicable in this case. Furthermore, the Commissioner's statement that the 1993 temporary regulation "does not alter the provisions of relevance to this case" is incorrect. *Id.* The second sentence in the applicable regulation (26 C.F.R. § 1.482-1A(b)(1)) is deleted from the 1993 temporary regulation. The Supreme Court relied, in part, on this sentence in *First Security*. 405 U.S. at 404-05. The Fifth Circuit and the Tax Court similarly relied on this provision of the regulation. Appendix to the Petition for a Writ of Certiorari ("Pet. App.") 8a, 105a.

[4] The "first oil crisis" occurred when world crude oil prices increased fourfold over a three-month period following the outbreak of the Arab-Israeli war on October 7, 1973. Pet. App. 33a-35a.

tainties caused by the Iranian Revolution, the takeover of the U.S. Embassy in Iran, the U.S. trade embargo against Iran, and the Iran-Iraq war. Pet. App. 40a-41a, 65a. In an effort to relieve the crisis, the U.S. Government and the governments of the other consuming countries repeatedly urged the Saudi Government to moderate crude oil prices. Pet. App. 42a, 68a-75a, 113a n.35, 114a. In response to these requests, the Saudi Government both increased its production and set its official selling price ("OSP") of Saudi crude lower than the selling prices set by other oil-producing countries for crude oils of similar grade or quality. As part of this price moderation policy, the Saudi Government, with the approval of the King, mandated that purchasers of its crude not resell Saudi crude for more than the OSP. Pet. App. 42a-45a, 120a-122a. The Tax Court found that "[p]rominent U.S. officials believed that the [Saudi Government's] price moderation policies were designed to obtain the defense and foreign policy support of the United States and to meet the need for stability in the world economy." Pet. App. 68a.

The Saudi Government sold its crude by way of the Arabian American Oil Company ("Aramco") to the Aramco shareholders, including Texaco, and to Petromin, the Saudi Arabian national oil company.[5] The Aramco

[5] Since 1948 and through the years at issue, Texaco, Exxon Corporation ("Exxon"), Chevron Corporation ("Chevron"), and Mobil Oil Corporation ("Mobil") (or their predecessor corporations) owned all of the stock of Aramco. Pet. App. 19a. In 1933, Aramco acquired the oil concession for Saudi Arabia from the Saudi Government. Pet. App. 18a. By 1977, however, the Saudi Government had taken over 100 percent ownership of Aramco's oil-producing assets, and Aramco merely provided services to the Saudi Government for a fee. Pet. App. 33a. The Saudi Government's takeover of Aramco was an exercise of its "sovereign power" and "was forced upon the Aramco shareholders against their will." Pet. App. 142a. The Saudi Government's actions followed similar actions by other oil-exporting countries, who terminated concessions and nationalized or expropriated producing operations in their countries during the 1970s. Pet. App. 29a-31a.

shareholders and Petromin then marketed Saudi crude to customers who transported the crude to refineries located throughout the world. Pet. App. 19a & n.4, 22a-23a, 25a, 32a-33a, 145a. The Saudi Government mandated that the Aramco shareholders and purchasers from Petromin not resell Saudi crude at prices higher than the OSP. Pet. App. 123a-124a. This restriction was initially communicated to the Aramco shareholders by a letter, dated January 23, 1979, from the Petroleum Ministry of Saudi Arabia, signed by Minister Ahmed Zaki Yamani (referred to as "Letter 103/Z"). Pet. App. 3a, 42a-44a. Letter 103/Z was unilaterally issued, and the Aramco shareholders did not negotiate, solicit, urge, or even influence the issuance of Letter 103/Z. Pet. App. 114a, 148a-149a. The Saudi Government restriction applied to all sales of Saudi crude by the Aramco shareholders, whether to related or unrelated customers. Pet. App. 133a. Texaco and the other Aramco shareholders were required to comply with the restriction by the Saudi Government and by the governments of the consuming countries, including the U.S. Government. Pet. App. 68a-75a, 124a-127a, 134a-155a. The Tax Court found that, "[a]fter the [Saudi Government] restriction was issued, official U.S. policy was strongly in favor of enforcing the restriction and seeing that the Saudi policy toward moderation was carried out." Pet. App. 68a. The Tax Court concluded that the Saudi Government restriction was "the virtual equivalent of law." Pet. App. 158a; *accord* Pet. App. 6a.

The Saudi Government restriction applied to the sale of Saudi crude and thus assured delivery of Saudi crude into consuming countries at the OSP. The restriction did not apply to the sale of products refined from Saudi crude, and the Saudi Government recognized that it "could not control product prices" in the consuming countries. Pet. App. 161a. In public statements, however, Minister Yamani stressed that the consuming country governments were responsible for controlling refined product prices. Pet. App. 45a-46a, 48a, 52a-53a, 94a-95a, 161a-162a.

Many consuming countries had product price controls in effect during 1979-1981, and certain countries directly established the price of refined products by reference to the import price of crude. Officials of consuming country governments—including the United States, the United Kingdom, Germany, France, Italy, the Netherlands, and Japan—understood that the restriction was imposed to ensure that Saudi crude reached the consuming countries at the lower Saudi price. Pet. App. 68a-75a, 124a-127a.

Texaco had to comply with the Saudi Government restriction to have access to Saudi crude. Pet. App. 57a, 142a-143a. Continued access to Saudi crude was critical to Texaco, because Saudi crude made up more than seventy-five percent of its international crude oil supply during the years in issue. Pet. App. 41a. If Texaco had violated the restriction, the Saudi Government could have cut off Texaco's access to Saudi crude, excluded Texaco from Saudi Arabia, or nationalized Texaco's assets in Saudi Arabia. Pet. App. 57a-60a, 142a-144a & n.46. In addition, the consuming countries had established an elaborate worldwide system for monitoring the prices at which crude was bought and sold, and this monitoring ensured compliance with the Saudi Government restriction. Pet. App. 153a-154a.

Texaco International Trader Inc. ("Textrad"), a domestic subsidiary of Texaco Inc., was the international trading company for the Texaco group during the period at issue.[6] Pet. App. 23a. Textrad acquired Saudi crude

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[6] Texaco Inc. is the parent corporation of a group of domestic and foreign corporations engaged in the production, refining, transportation, and marketing of crude oil and refined products in the United States and foreign countries. Respondents are the members of the Texaco group that joined in Texaco's U.S. consolidated income tax return. Pet. App. 18a. In general, foreign corporations cannot join in a consolidated return (26 U.S.C. § 1504(b)(3)) and are not directly subject to U.S. tax on their foreign income, but the foreign income of controlled foreign corporations is indirectly subject to U.S. tax under 26 U.S.C. §§ 951-964.

from Aramco at the OSP and, in compliance with the Saudi Government restriction, resold Saudi crude to Texaco's affiliates and to unrelated customers at prices not higher than the OSP. Texaco's foreign and domestic affiliates refined Saudi crude and other crude into products for sale in the countries where they operated. Pet. App. 2a, 23a-25a, 187a. Texaco's affiliates reported profits from the sale of products refined from Saudi crude in their tax returns for the consuming countries in which they operated, including the United States, the United Kingdom, Belgium, Germany, Italy, and Sweden.[7] Pet. App. 24a-25a, 72a-74a nn.14-18, 94a.

During the period at issue, Textrad sold approximately thirty-four percent of its Saudi crude (780 million barrels) to Texaco's refining affiliates. Pet. App. 3a, 24a. Of this amount, approximately 275 million barrels were sold to Texaco's domestic refining company and 505 million barrels were sold to Texaco's foreign refining affiliates. Pet. App. 3a-4a. In addition, Textrad sold approximately twenty-two percent (494 million barrels) of its Saudi crude to Caltex Petroleum Corporation ("Caltex").[8] Textrad also sold almost twenty percent (444 million barrels) of its Saudi crude to customers that were completely unrelated to Texaco.[9] Pet. App. 4a, 24a. The

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[7] One of Texaco's foreign affiliates was Texas Overseas (Bermuda) Limited ("TOBL"), a Bermuda corporation that refined crude at a refinery located in Bahrain. TOBL was not subject to tax in Bermuda or in Bahrain. The Tax Court found that this arrangement was unrelated to the Saudi Government restriction because TOBL's operations commenced in 1976. Pet. App. 179a-181a. The Commissioner made an alternative adjustment allocating TOBL's income to Textrad, and the parties settled that adjustment.

[8] Caltex is a domestic corporation owned fifty percent by Texaco Inc. and fifty percent by Chevron. Pet. App. 23a.

[9] Textrad purchased and sold 367 million barrels of Saudi crude to unrelated customers at the OSP. Textrad purchased and sold 77 million barrels of Saudi crude to unrelated customers expressly designated by the Saudi Government to receive "war relief" crude. Pet. App. 24a, 65a-66a.

volume and pattern of Textrad's sales and other dispositions of Saudi crude during 1979-1981 were consistent with its sales and other dispositions in prior years.[10] Pet. App. 4a, 64a, 85a-86a, 91a.

The Commissioner increased Textrad's income for 1979-1981 on its sales of Saudi crude to Texaco's foreign affiliates under sections 61 and 482 of the Internal Revenue Code.[11] The Commissioner alleged that Textrad shifted profits attributable to the lower cost of Saudi crude out of Texaco's U.S. taxable income by selling Saudi crude at the OSP to Texaco's foreign affiliates. Pet. App. 2a, 98a. The Commissioner made a similar adjustment with respect to Exxon. Pet. App. 99a-100a. The Tax Court consolidated Texaco's and Exxon's cases for trial of this adjustment. Pet. App. 14a n.1.

II. THE PROCEEDINGS BELOW

A. *Tax Court.* Following a five-week trial, the Tax Court issued a detailed opinion numbering almost 200 pages. The Tax Court held that "[u]nder the rule of *Commissioner v. First Security Bank*, 405 U.S. 394 (1972), its assignment of income predecessors, and its progeny," the Saudi Government restriction "precluded a section 61 or section 482 adjustment to the income of

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[10] In addition to selling Saudi crude, consistent with its historical business practices, Textrad also refined Saudi crude and exchanged Saudi crude for non-Saudi crude in order to facilitate Texaco's refining operations. Pet. App. 83a-86a, 89a-91a. Textrad realized profits from sales of refined products and from sales of non-Saudi crude, and those profits were reported in Texaco's U.S. income tax return. Pet. App. 90a, 163a. The Tax Court found that those profits did not violate the Saudi Government restriction and that Textrad could not have changed its operations in order to capture additional profits from Saudi crude because "deviations from historical behavior would have been objected to by the Saudis." Pet. App. 180a; *see id.* 170a, 179a, 181a.

[11] The Commissioner also increased Textrad's income on its sales of Saudi crude to Caltex, but that adjustment was only a small portion of the total adjustment at issue in this case.

[Textrad] in this case." Pet. App. 187a. The Tax Court noted that *First Security* and related cases "stand for the proposition . . . that 'in order to be taxed for income, a taxpayer must have complete dominion over it.' " Pet. App. 111a-112a, citing *First Security*, 405 U.S. at 403. If, as in *First Security*, "the receipt of income is prohibited by law, the Commissioner is prohibited from allocating such income pursuant to section 482." Pet. App. 106a.

Addressing the Commissioner's adjustment under section 61, the Tax Court recognized that *United States v. Basye*, 410 U.S. 441, 449 (1973), and other assignment of income cases hold that " 'income must be taxed to him who earns it.' " Pet. App. 115a. It noted, however, that in applying the assignment of income doctrine, this Court "has consistently distinguished between taxpayers who voluntarily relinquish the right to receive income and taxpayers who are denied the right to receive income by operation of law." *Id.* Relying on *First Security*, the Tax Court concluded that "a taxpayer who is legally prohibited from receiving income and who does not in fact receive such income, cannot be said to have 'earned' the income under a section 61 analysis." Pet. App. 116a. Therefore, under the assignment of income doctrine, "the Commissioner cannot allocate income to a taxpayer who is legally prohibited from receiving it." Pet. App. 118a.

The Tax Court then determined whether the principle of *First Security* applied under the facts in this case.[12]

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[12] The Tax Court initially addressed the Commissioner's concern that "[i]ndiscriminate deference to foreign law [in applying section 482] would open the door to wide-scale collusion between taxpayers and foreign sovereigns engaged in commercial activity." Pet. App. 114a. Because of the potential for collusion, the Tax Court applied "a 'heightened scrutiny' of the evidence" of the Saudi Government restriction and found "no evidence" of collusion. Pet. App. 113a-114a & n.36. The Tax Court also rejected the Commissioner's argument that the principle of *First Security* did not apply where receipt of the income in question was precluded by foreign as opposed to domestic law. Pet. App. 111a-114a, citing *Procter &*

The Tax Court examined "whether the [Saudi Government] restriction constituted a valid and binding prohibition imposed by the [Saudi Government] against the sale of Saudi crude oil for an amount in excess of Saudi OSP." *Id.* The Tax Court found that the Saudi Government restriction was unilaterally imposed on Texaco and other resellers of Saudi crude and "was authorized by the King." [13] Pet. App. 119a-122a. The Tax Court also found that Texaco was required to comply with the restriction by both the Saudi Government and consuming country governments. Pet. App. 153a-155a.

In response to the Commissioner's argument that the restriction was merely a contract term, the Tax Court stated:

> We agree with [the Commissioner] that, if the restriction was a mere contract term, negotiated by [Texaco and Exxon] in the context of a commercial relationship, then the facts in *First Security* and *Procter & Gamble* would be distinguishable from the facts in this case. In such a circumstance, the restriction would not have deprived [Texaco and Exxon] of the power to control the location of income, and the rule of *First Security* and subsequent cases would not apply. If, on the other hand, the restriction required [Texaco and Exxon] to price Saudi crude as they did, then [the Commissioner's] allocation cannot stand.

Gamble Co. v. Commissioner, 961 F.2d 1255 (6th Cir. 1992). The Commissioner did not make that argument on appeal to the Fifth Circuit and does not make that argument in her petition. *See infra* note 23.

[13] The Tax Court found that the Saudi Government restriction "applied to all sales of Saudi crude"; was "in effect during the period at issue"; applied to "all four Aramco shareholders"; and "was imposed upon other than the Aramco shareholders." Pet. App. 123a, 124a, 133a, 158a. The Tax Court found "no evidence that certain purchasers were not required to resell Saudi crude at Saudi OSP." Pet. App. 124a.

Pet. App. 134a. The Tax Court found that "the restriction was not a negotiated contract term that [Texaco and Exxon] had the option of taking or leaving; the Saudis issued the restriction without discussion or negotiation," in "language of a mandatory, nonnegotiable, admonishing nature." Pet. App. 145a, 146a. The Tax Court found "no evidence that [Texaco and Exxon] urged the [Saudi Government] to issue the resale price restriction at issue here," or that the restriction was even the result of Texaco's and Exxon's "influence." Pet. App. 149a. The Saudi Government issued the restriction with "an underlying warning that failure to comply with Saudi requirements would have serious repercussions." Pet. App. 146a.

The Tax Court also rejected the Commissioner's argument "that the restriction was merely a commercial term consented to in the context of a commercial relationship." Pet. App. 137a. The Tax Court examined the "historical relationship" and "the specific facts leading up to the [Saudi Government] restriction." Pet. App. 143a. While the Tax Court recognized that "the relationship between [Texaco and Exxon] and the [Saudi Government] was in part commercial in nature in the sense that it involved the purchase and sale of crude oil," it found that the Saudi Government restriction itself "was not commercial in nature." Pet. App. 143a-144a. Based on all the facts, the Tax Court concluded that the Saudi Government restriction was not "a 'commercial' contract pricing term in which [Texaco and Exxon] made a negotiated, calculated concession." Pet. App. 149a. In addition, the Tax Court reasoned that "the Saudi power over the pricing of its crude was sovereign in nature from the inception of its relationship with [Texaco and Exxon]"; that "the subsequent takeover of Aramco by the [Saudi Government] was another exercise of the [Saudi Government's] sovereign power"; that the setting of crude prices by member countries of the Organization of Petroleum Exporting

Countries ("OPEC") "was inherently sovereign in nature"; and that the penalties for violating the restriction (cut off of crude supplies, nationalization of assets, and exclusion from Saudi Arabia) were not the type of penalties "that would have existed in a normal contractual relationship between private parties." Pet. App. 142a, 143a, 144a n.46.

The Commissioner also argued that the Saudi Government restriction was consensual because Texaco and Exxon "were not compelled to purchase Saudi crude on the terms and conditions sought by the Saudis." Pet. App. 147a. The Tax Court found that Texaco's and Exxon's relationship with the Saudi Government "went to the very heart of [Texaco's and Exxon's] livelihood as international marketers of crude oil to third parties and to their refining affiliates." *Id.* Texaco and Exxon did not have the "choice" whether to buy Saudi crude, because "to choose to cut off a significant percentage of their crude supply was not a realistic option." Pet. App. 148a.

Based on all the facts, the Tax Court concluded that "the Saudi restriction was the virtual equivalent of law and constituted a valid and binding prohibition against the sale of Saudi crude for an amount in excess of Saudi OSP." Pet. App. 158a. The Tax Court then found that "[Texaco and Exxon] complied with the restriction in all material respects." Pet. App. 187a. Therefore, the Tax Court held that the Saudi Government restriction "precluded a section 61 or section 482 adjustment" to Textrad's income. *Id.*

B. *Fifth Circuit.* The Commissioner appealed to the Fifth Circuit, which unanimously affirmed the Tax Court.[14] The Fifth Circuit reviewed the Tax Court's

[14] The Tax Court has not entered a final decision in Exxon's case, due to other issues not yet resolved. Any appeal of Exxon's case likely would be to the Second Circuit.

factual findings and determined that they were "not clearly erroneous." Pet. App. 6a. The Fifth Circuit concluded that "[t]he Tax Court's findings of fact fully support[ed]" its conclusions that the Saudi Government restriction "had the effect of a legal restriction in Saudi Arabia" and "should be given the effect of law for purposes of §§ 482 and 61." *Id.*

The Fifth Circuit "agree[d] with the Tax Court's legal conclusion that the teaching of *Commissioner v. First Security Bank*, 405 U.S. 394 (1972), bars the Commissioner from allocating income to Textrad on its sales of Saudi crude under § 482. Because the sales price of the crude is governed by [the Saudi Government restriction], Texaco did not have the power to control the sales price of the oil." Pet. App. 6a (parallel citations omitted). The Fifth Circuit pointed out, as the Supreme Court did in *First Security*, that "the Commissioner's own regulations for implementing § 482 contemplate that the controlling interest 'must have "complete power" to shift income among its subsidiaries.' " Pet. App. 8a. The Fifth Circuit held:

> It is precisely this ability to control the flow of its income that Texaco lacked. The Tax Court found, and we agree, that [the Saudi Government restriction] had the force and effect of law, that Textrad was obligated to comply with its requirements, and that it did so comply. Because Textrad lacked the power to sell Saudi crude above the OSP, reallocation under § 482 is inappropriate.

Pet. App. 10a.

The Fifth Circuit rejected the Commissioner's assignment of income argument and reliance on the Supreme Court's decision in *United States v. Basye*, 410 U.S. 441 (1973). The Fifth Circuit concluded that "nothing in *Basye* is contrary to the principles discussed above." Pet. App. 11a. The Fifth Circuit examined the Court's reasoning in *Basye* and concluded that it "turned on the

consensual nature of the agreement and is entirely consistent with the principles of control expressed in the regulations adopted under § 482 and in *First Security*." *Id.* By contrast, "where, as here, the taxpayer lacks the power to control the allocation of the profits, reallocation under § 482 is inappropriate." Pet. App. 12a.

The Fifth Circuit also stated that the Commissioner's proposed allocation would not "be consistent with § 482's goal of achieving tax parity between controlled and uncontrolled taxpayers." *Id.* The standard of tax parity as reflected in the Commissioner's regulations is "an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." *Id.*, citing 26 C.F.R. § 1.482-1A (b)(1). The Fifth Circuit reviewed the record evidence and concluded that it "fully supports the Tax Court's findings that Textrad sold significant amounts of Saudi crude to unrelated customers at the same OSP it sold to its affiliates, that the volume of Textrad's sales of Saudi crude to unrelated customers during this period remained generally consistent with historic levels, and that any changes in Textrad's sales to its affiliates and its unrelated customers during this period had no nexus with the restrictions imposed by [the Saudi Government]." Pet. App. 12a-13a. Therefore, the Fifth Circuit concluded, "the Tax Court did not err in concluding that the Commissioner failed to demonstrate any disparity between Texaco's treatment of its affiliates and its unrelated customers as a result of the Saudi price restrictions. Thus, under the regulation's tax parity standard, the Commissioner's allocation of Texaco's income under § 482 is improper." Pet. App. 13a.

REASONS FOR DENYING THE WRIT

The issue in this case—whether the Saudi Government restriction was a legal restriction or a consensual agreement—is narrow, largely fact-based, of no general importance, and correctly decided by the courts below. The courts below found that, during the period 1979-1981, the Saudi Government required Texaco to charge below-market prices on all sales of Saudi crude, whether to related or unrelated customers. In compliance with that mandate, Textrad actually sold 367 million barrels of Saudi crude to unrelated customers at the Saudi-mandated price. Applying the principles established in *Commissioner v. First Security Bank*, 405 U.S. 394, 404 (1972), the courts below found that the Saudi Government restriction deprived Texaco of the " 'complete power' to shift income among its subsidiaries." Pet. App. 8a, 10a, 106a, 158a. The courts below also found that recognition of the restriction achieved "tax parity" since there was no "disparity between Texaco's treatment of its affiliates and its unrelated customers as a result of the Saudi price restrictions." Pet. App. 13a; *accord* 186a-187a.

The Commissioner primarily urges review on the ground that the Saudi Government restriction was a "consensual commercial arrangement," thereby allegedly making the principles of *United States v. Basye*, 410 U.S. 441 (1973), controlling. The courts below thoroughly considered the Commissioner's argument and found that there was "no evidence" that the price restriction was a product of "collusion" or "negotiations" between Texaco and the Saudi Government, or that Texaco solicited or even "influence[d]" issuance of the restriction. Pet. App. 114a, 148a, 149a; *accord* Pet. App. 5a. Rather, they determined that the restriction was "a valid and binding prohibition" authorized by the King and unilaterally imposed on Texaco and other resellers of Saudi crude oil to ensure delivery of Saudi crude to refiners at the Saudi OSP, as part

of the Saudi Government's price moderation policy adopted at the urging of the U.S. Government and other consuming country governments. Pet. App. 3a, 6a, 122a, 158a. Under these facts, there is no support for the Commissioner's argument that the Saudi Government restriction was a consensual agreement because Saudi Arabia was also the supplier of Saudi crude oil. This Court, in other contexts, has frequently made clear that governments engaged in commerce retain their sovereign power to regulate in the public interest. *See, e.g., United States v. Winstar Corp.*, 116 S. Ct. 2432, 2458, 2465-67 (1996); *Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130, 145-47 (1982). The Tax Court expressly found that the Saudi Government restriction itself "was not commercial in nature." Pet. App. 144a. The Commissioner offers no good reason for this Court to second-guess this determination under the facts in this case.

The Commissioner also fails to demonstrate that this case is of any broad or continuing significance. The proper characterization of the Saudi Government restriction is of importance to only two taxpayers and, then, only for the years 1979-1981. The Commissioner's assertion that the result in this case will encourage collusion between taxpayers and foreign governments, at the expense of the U.S. Treasury, is simply not justified. The Tax Court properly addressed this concern and applied "heightened scrutiny" of the Saudi Government restriction due to its foreign origin and Texaco's commercial relationship with the Saudi Government. There is no reason for this Court to disturb the Tax Court's finding that there was no evidence of collusion between Texaco and the Saudi Government in this case. Pet. App. 113a-114a. Thus, the petition should be denied.

1. The decision below rests upon the established legal principle that the Commissioner is not free "to allocate income to a party prohibited by law from receiving it." Pet. App. 7a, citing *First Security*, 405 U.S. at 404. As

this Court observed more than two decades ago, "[i]n cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it." *First Security*, 405 U.S. at 403. In applying section 482, the central question is whether the controlling taxpayer has "complete dominion" over the income that the Commissioner seeks to allocate—that is, it must have " 'complete power' to shift income among its subsidiaries." *Id.* at 403, 404. "It is only where this power exists, and has been exercised in such a way that the 'true taxable income' of a subsidiary has been understated, that the Commissioner is authorized to reallocate under § 482." *Id.* at 404-05. Applying those standards, the Fifth Circuit agreed with the Tax Court that, given the legal, mandatory nature of the restriction imposed by the Saudi Government, "it [was] precisely this ability to control the flow of its income that Texaco lacked." Pet. App. 10a; *see First Security*, 405 U.S. at 405 (power to control income "hardly includes the power to force a subsidiary to violate the law").[15]

The Fifth Circuit also stated that, in this case, reallocation would not "be consistent with § 482's goal of achieving tax parity between controlled and uncontrolled

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[15] According to the Commissioner, "[t]he court of appeals erred in implying that whether the resale price restriction in Letter 103/Z was a Saudi 'law' was a question of fact to be reviewed under the clearly erroneous standard." Pet. 20 n.12. But this is an obvious misreading of the Fifth Circuit's opinion. That court plainly stated: "*Based on* the Tax Court's factual findings, which are not clearly erroneous, we agree that Letter 103/z had the effect of a legal restriction in Saudi Arabia." Pet. App. 6a (emphasis added). That analysis is entirely correct. The Fifth Circuit reviewed the legal conclusions of the Tax Court for error and the factual findings on which they were based for clear error. *See United States v. Lulac*, 793 F.2d 636, 642 (5th Cir. 1986); *Estate of Bailey v. Commissioner*, 741 F.2d 801, 803-04 (5th Cir. 1984); *Remington Rand Corp. v. Business Sys., Inc.*, 830 F.2d 1260, 1263-65 (3d Cir. 1987).

taxpayers." Pet. App. 12a, citing *First Security*, 405 U.S. at 407. The governing regulation establishes that "[t]he purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer." 26 C.F.R. § 1.482-1A(b)(1); *see* Pet. App. 12a. In compliance with the Saudi Government restriction, Textrad sold 367 million barrels of Saudi crude "to unrelated customers at the same OSP it sold to its affiliates." Pet. App. 12a. These transactions establish a benchmark of "arm's length" sales against which the sales of Saudi crude to affiliated buyers can be measured. Thus, there is no basis to conclude that Texaco was improperly shifting income by selling Saudi crude to its own subsidiaries at the OSP.[16]

2.A. Relying on *Basye*, the Commissioner's principal argument is that the holding of *First Security* does not apply to a "consensual agreement."[17] *See* Pet. 12, quoting *Basye*, 410 U.S. at 453 n.13. Both courts below agreed with this proposition but rejected the Commissioner's contention that the Saudi Government restriction was a consensual agreement. Pet. App. 10a-12a, 134a, 146a-149a.

The Commissioner continues to argue that the Saudi Government restriction was consensual. Pet. 19 ("the Saudi resale price restriction represents a consensual, com-

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[16] The Tax Court found that the volume of Textrad's sales of Saudi crude to unrelated customers during the years at issue remained consistent with historic levels and that any changes in Textrad's pattern of sales were not related to the Saudi Government restriction. Pet. App. 64a.

[17] In *Basye* the deflection of income did not result from a legal restriction imposed by a government. Rather, *Basye* involved an agreement between a partnership of doctors and a health maintenance organization to provide medical services in return for a base compensation plus the payment of retirement benefits to a trust. This Court expressly distinguished *First Security* on the basis that it "involved a deflection of income imposed by law, not an assignment arrived at by the consensual agreement of two parties acting at arm's length as we have in the present case." 410 U.S. at 453 n.13.

mercial arrangement"); *see also* Pet. 17 ("consensual arrangement"), 18 ("consensual commercial arrangement"). But the contrary conclusion of the courts below is fully supported, and compelled, by the record. Furthermore, the characterization of one particular restriction, of narrow application at the time and long since defunct, does not merit review by this Court. While the Commissioner argues that her view "finds support not only in the facts of this case but also in a long and consistent line of decisions of this Court concerning governmental immunity," a review of the relevant facts and law leads to the opposite conclusion. Pet. 19-20 (citation omitted).

The Tax Court concluded that "there is no evidence that would support [the Commissioner's] claim that the price restriction was a product of voluntary negotiations between [Texaco and Exxon] and the [Saudi Government]." Pet. App. 148a. To the contrary, it found "that the restriction was not a negotiated contract term that [Texaco and Exxon] had the option of taking or leaving; the Saudis issued the restriction without discussion or negotiation." Pet. App. 145a; *see also id.* at 146a (noting that the language of Letter 103/Z was "of a mandatory, non-negotiable, admonishing nature"). The Tax Court also reviewed in detail the historical background of the dealings between Texaco and Saudi Arabia. In particular, it pointed out that Saudi Arabia, in a prior "exercise of [its] sovereign power," had taken over Aramco against the will of its shareholders (including Texaco). Pet. App. 142a. Observing that Saudi Arabia "possessed the ultimate weapon of nationalization," the court found that "[t]here was an aspect of control by the Saudis here that went far beyond a private party's contractual power to negotiate and enforce a contract term." Pet. App. 142a, 143a. That degree of control, likewise, supported the conclusion that the Saudi Government restriction "was not a 'commercial' contract pricing term in which [Texaco and Exxon] made a negotiated, calculated concession." Pet. App. 149a.

Since there is no evidence that Texaco solicited, negotiated, or influenced the restriction, the Commissioner argues that Texaco consented to the restriction by "*consenting* to purchases of oil subject to the Saudi restriction." Pet. 18. The issue under section 482 is not whether Texaco could have avoided the restriction by not purchasing Saudi oil. The issue is whether Texaco could have purchased the oil and resold it at a price higher than the restricted price, thus earning on those sales the profit that the Commissioner seeks to allocate. *See First Security*, 405 U.S. at 404-05. The courts below found that, as a result of the Saudi Government restriction, Texaco did not have the choice to sell Saudi crude for more than the restricted price. Pet. App. 6a, 12a, 158a. Further, under the Commissioner's argument, every deflection of income that results from a legal restriction would be consensual. For example, the banks in *First Security* chose to offer credit life insurance to their customers. Likewise, the husband and wife in *Poe v. Seaborn*, 282 U.S. 101, 117 (1930), chose to live in Washington state and thus were subject to Washington law under which the husband's wages were the income of the marital community. But the choices that subjected the taxpayers to legal restrictions in these cases did not make the resulting deflection of income "consensual." Likewise, Texaco's purchase of Saudi crude did not make any deflection of income resulting from compliance with the Saudi Government restriction consensual.

2.B. The Commissioner tries to salvage her position that the Saudi Government restriction was consensual by claiming that "when a government undertakes a commercial activity, it acts in a commercial, not sovereign, capacity." Pet. 20. If the Commissioner is arguing that *some* actions of a sovereign engaged in commerce are treated as private acts, the Commissioner is correct. The courts below agreed that not all governmental actions are sovereign in nature, but found that this particular edict was a sovereign act. To the extent that the Commissioner ar-

gues that the restriction must be deemed consensual simply because Saudi Arabia was the producer and supplier of Saudi crude oil, the argument runs head-on into the well-recognized principle that sovereigns engaged in commercial activities nonetheless retain the sovereign power to regulate in the public interest. *See, e.g., United States v. Winstar Corp.*, 116 S. Ct. 2432, 2458, 2465-67 (1996); *Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130, 145-47 (1982).

This Court has frequently made clear that "[c]ontractual arrangements," including those to which a sovereign itself is a party, "remain subject to subsequent legislation by the presiding sovereign." *Jicarilla*, 455 U.S. at 147-48 & cases cited therein. Thus, a sovereign engaged in commerce may operate both as a contractor and as a sovereign.[18] *See generally United States v. Winstar Corp.*, 116 S. Ct. 2432 (1996). Given that dual capacity, it follows that sovereign governments and U.S. taxpayers *might* enter into purely contractual arrangements that, upon a proper showing, the Commissioner would be entitled to disregard for purposes of section 482. But a sovereign may also exercise its sovereign power wholly without regard to the "consent" of its contractual partners. Thus, "[w]hatever place consent may have in contractual matters and in the creation of democratic governments, it has little if any role in measuring the validity of an exercise of legitimate sovereign authority."[19] *Jicarilla*, 455 U.S. at 147.

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[18] In her foreign tax credit regulations, the Commissioner has recognized that a foreign government may simultaneously act both as a sovereign and as a commercial party. *See* 26 C.F.R. § 1.901-2(a)(2)(i) (1983) (amended 1991). These regulations provide that, depending on the facts and circumstances, a foreign government that has a commercial relationship with the taxpayer may also, in its sovereign capacity, impose a tax on the taxpayer.

[19] Although the Commissioner relies on the Foreign Sovereign Immunities Act of 1976, 28 U.S.C. §§ 1602-1611, and the decision in *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607 (1992), neither sheds much light on whether the Saudi Government restric-

The record evidence supports the decision below that the Saudi Government was exercising its sovereign powers in issuing the restriction. In addition to pointing out the unilateral nature of the edict and its approval by the King, the Tax Court found that the Saudi Government had imposed the restriction as part of its price moderation policy adopted at the urging of the U.S. Government and the governments of other consuming countries.[20] That policy began with the decision by Saudi Arabia to sell its oil at a lower price than the price set by other oil-producing countries, and the restriction on the resale price of Saudi crude was intended to ensure that the crude

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tion was a legal restriction that Texaco was required to obey. Nothing in the Act is inconsistent with the basic principle that a sovereign may engage in an activity both as a commercial entity and as a sovereign, and this Court has recognized the intermingled existence of both roles. *See Saudi Arabia v. Nelson*, 507 U.S. 349, 358 n.4 (1993) (declining to "address the case where a claim consists of both commercial and sovereign elements"). And, in *Weltover*, the Court held only that action by Argentina to change the terms of *its own transactions*—that is, extending the period for repayment of its debt—was sufficiently commercial in nature to deny it immunity from suits to collect on that debt. Here, by contrast, the restriction imposed by Saudi Arabia applies not to its own transactions, but to subsequent transactions between resellers of crude oil and their customers. *See South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 99 (1984) (plurality opinion) ("downstream restrictions have a greater regulatory effect than do limitations on the immediate transaction").

[20] The Tax Court found that the price moderation policy was designed to obtain the defense and foreign policy support of the United States, to stabilize the world economy, and to protect the long-term interests of Saudi Arabia in its abundant oil reserves. Pet. App. 68a, 114a, 124a-127a, 153a n.48. The Tax Court also found that the consuming country governments, including the United States, were very much aware of the terms of the Saudi Government restriction; that the Saudi Government made public statements about the scope and nature of the restriction, which were widely publicized during the period at issue; and that the nature of the Saudi Government restriction was common knowledge throughout the world. Pet. App. 45a-48a, 52a-53a, 68a-75a, 121a-122a.

reached the consuming countries at the lower Saudi price. The Fifth Circuit concluded, based on the Tax Court's findings, that the Saudi Government imposed the restriction to ensure that its price moderation policy "had its intended effect." Pet. App. 3a. Under these facts, the Saudi Government was acting as a sovereign when it issued the restriction.[21]

In an attempt to support her argument that the Saudi Government restriction was nothing more than a commercial arrangement, the Commissioner asserts that the Saudi Government "planned" and "contemplated" that its price moderation policy, including the restriction, would put additional profits into the "pocket" of the Aramco shareholders. Pet. 14, 24. The facts contradict those assertions. While Minister Yamani stated publicly that the Saudi Government would "follow the barrel of Saudi crude until it lands at a certain refinery and we know that it is sold at our price," and that "I cannot do anything after that," he added that "*It is the consumers' responsibility.*"[22] Pet. App. 46a, 48a (emphasis added). Many consuming countries had product price controls or other measures in effect during 1979-1981 that limited the product profits realized by the Aramco shareholders. Pet. App. 68a-75a & nn.14-18. Further, the Tax Court found that, in compliance with the restriction, Texaco and Exxon sold Saudi crude to both affiliated and unaffiliated customers at the OSP. Pet. App. 21a, 24a, 185a, 186a.

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[21] *See Building & Constr. Trades Council v. Associated Builders & Contractors*, 507 U.S. 218, 229 (1993) (distinguishing situations in which a state "acts as a regulator" from situations in which it "acts as a market participant with no interest in setting policy"); *see also South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 96 (1984) (plurality opinion) (factors showing that state acted as regulator included "foreign commerce, a natural resource, and restrictions on resale").

[22] The Commissioner's quotations of Minister Yamani conspicuously omit his statements that controlling profits from refined products is the consuming countries' responsibility. Pet. 6 & n.3.

Thus, the Saudi Government restriction had its intended effect: it prevented the Aramco shareholders and others from reselling Saudi crude for more than the OSP and it assured delivery of Saudi crude to refineries at the Saudi-mandated price.

3. The Commissioner seeks to distinguish *First Security* from this case on the grounds that the Saudi Government did not prohibit Texaco from profiting from sales of products refined from Saudi crude and did not prohibit Texaco from engaging in the business of buying and selling crude.[23] Pet. 16-17. The Commissioner contends that in *First Security* "the taxpayer could not lawfully engage in the commerce that produced the income." Pet. 16. According to the Commissioner, the present case is different because Texaco "was lawfully engaged in the business of buying and selling crude oil" and could and did profit from sales of refined products. Pet. 16-17. But the relevant issue under section 482 is not whether the taxpayer can lawfully engage in a particular business; the issue is whether it can lawfully earn the income that the Commissioner seeks to allocate to it. Here, the Commissioner seeks to increase Textrad's income on sales of Saudi crude to Texaco's affiliates. Textrad could not earn that income because it could not lawfully sell Saudi crude oil at a higher price than that established by the Saudi Government. The Tax Court further found that all Texaco affiliates were prohibited from selling Saudi crude for more than the price mandated by the Saudi Government.

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[23] The Commissioner does not contend that the principle of *First Security* does not apply to a foreign government restriction. The Commissioner merely notes that she "disagrees" with the Sixth Circuit's conclusion in *Procter & Gamble* "that *First Security Bank* applies where the law prohibiting the receipt of income is that of a foreign country." Pet. 17 n.10. The Commissioner did not make that argument before the Fifth Circuit, and she has accepted, in her own regulation, the premise that a foreign legal restriction may bar an allocation under section 482 in certain circumstances. *See* Treas. Reg. §§ 1.482-1(h)(2), (j)(1) (1994), effective for taxable years beginning after October 6, 1994.

Pet. App. 123a-124a, 158a. In *First Security*, this Court barred allocation of a share of insurance premiums to the banks even though members of the affiliated group (other than the banks) were allowed to engage in the insurance business and to receive insurance premiums. 405 U.S. at 402.

The artificial nature of the Commissioner's attempts to distinguish *First Security* is readily apparent from the Court's reasoning in *First Security*. There, the Court relied on the Tax Court's prior decision in *L. E. Shunk Latex Products, Inc. v. Commissioner*, 18 T.C. 940 (1952), which involved a "closely analogous situation." 405 U.S. at 406. Like the present case, *Shunk Latex* involved a corporation that could lawfully engage in the commerce that produced the income but could not lawfully earn the income at issue because of a governmentally imposed price ceiling.[24] 18 T.C. at 959. Further, in *Shunk Latex* the profit associated with the higher price was received and retained by an affiliated person. *Id.* Yet this Court quoted with approval the conclusion of the Tax Court that the Commissioner had "no authority to attribute to petitioners income which [by virtue of the price ceiling] they could not have received." 405 U.S. at 406, quoting 18 T.C. at 961; *accord Lehman v. Commissioner*, 25 T.C. 629, 633-34 (1955). In this case, the Commissioner seeks to increase Textrad's income on sales of Saudi crude even though all Texaco affiliates were prohibited from selling Saudi crude for more than the re-

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[24] Although the Commissioner claims that the subsidiary to which she reallocated the income (Textrad) earned it as a matter of "economic reality," that view is mistaken. Pet. 19. The Tax Court found that Textrad was prohibited from engaging in the activity—selling Saudi crude for more than the mandated price—that would have produced the income that the Commissioner seeks to allocate in this case. Pet. App. 158a. Furthermore, the Tax Court found that Textrad could not have changed its operations in order to capture additional profits from Saudi crude because "deviations from historical behavior would have been objected to by the Saudis." Pet. App. 180a.

stricted price. Thus, as in *First Security* and *Shunk Latex*, the Commissioner in this case is seeking to allocate to the taxpayer income that it was prohibited from receiving.

4. The Commissioner appears to acknowledge that the characterization of the Saudi Government restriction as a legal restriction or a consensual agreement is of current significance to only two taxpayers, Texaco and Exxon. This narrow application is hardly surprising. The issue arises out of an oil crisis occurring almost twenty years ago and an extraordinary price moderation policy adopted by the Saudi Government at the urging of the U.S. Government.

To broaden the potential impact of the decision below, therefore, the Commissioner raises the specter that taxpayers may "encourage or endure the adoption of profitable foreign 'legal restrictions' " at the expense of the U.S. Treasury. Pet. 25. But this concern is not justified. The Tax Court recognized the possibility that a foreign legal restriction might be the result of collusion with a private taxpayer, and it subjected the restriction to "heightened scrutiny" to assure that collusion was not present. Pet. App. 113a, citing *Procter & Gamble Co. v. Commissioner*, 961 F.2d 1255, 1259 (6th Cir. 1992). It found, however, that "despite [the Commissioner's] expressed fears, there is no evidence of such collusion in this case." Pet. App. 114a; *see also id.* (noting "sufficient evidence in the record of Saudi self-interest in issuing the restriction—particularly in terms of its close relationship with the U.S. Government, which encouraged price moderation at the time"). Moreover, in order to bring itself within the facts of this case, a taxpayer would be required to orchestrate an extraordinary series of global events and U.S. and foreign government actions and policies.

Finally, the Commissioner points to the amount of taxes in dispute.[25] But the amount in dispute, standing alone, provides no proper ground for granting review. Section 482 does not authorize the Commissioner to reallocate income simply because that action will result in more tax revenue to the U.S. Treasury. Rather, it provides for reallocation when a taxpayer, by virtue of its "complete power" over the income, has shifted income between controlled parties so that the "true taxable income" of the taxpayer has not been clearly reflected. *See First Security*, 405 U.S. at 404-05. The courts below merely decided that this particular taxpayer, as the result of a particular legal restriction imposed by the Saudi Government, did not have or exercise that power. That conclusion does not warrant further review.

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[25] The Commissioner computes the tax due as more than $1 billion, whereas the actual asserted tax deficiency is approximately $800 million. Pet. 12. In addition, the Commissioner has assumed that the amount asserted as the deficiency for Texaco is correct. But the Tax Court has not ruled on the amount of the adjustment, only on the Commissioner's power to make an adjustment at all.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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